No. 15710

IN THE

UNITED STATES COURT OF APPEALS

For the Ninth Circuit

JACK SHOWELL AND DOROTHY SHOWELL,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF FOR PETITIONERS

On Petitions for Review of the Decisions of The Tax Court of the United States

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OPINIONS BELOW

There have been two opinions of the Tax Court of the United States in this case. The first, a regular opinion, was promulgated December 16, 1954, and the findings of fact and opinion of the Tax Court are reported at 23 T. C. 495. The second, a memorandum opinion, after remand by this Court, was promulgated January 31, 1957, and the findings of fact and opinion of the Tax Court, although not officially published, may be found at 16 TCM 103, Dec. 22, 239 (M), T. C. Memo. 1957-22.

JURISDICTION

This appeal involves income taxes. By two notices of deficiency, each dated February 26, 1953, addressed separately to Jack Showell and Dorothy Showell, the Commissioner of Internal Revenue determined deficiencies of $3,946.65, and $4,065.69 respectively for the taxable year 1949 (R. No. 14760 at 6, 7, 121). Identical petitions, under the authority of Section 272 (a) of the Internal Revenue Code of 1939, were filed with the Tax Court of the United States on April 30, 1953, seeking a redetermination of the deficiency set forth in each notice of deficiency (R. No. 14760 at 4, 121). The first decisions of the Tax Court were entered on January 26, 1955 (R. No. 14760 at 27, 28). Those decisions found that there was a deficiency in income tax for Jack Showell in the amount of $3,286.65, and a deficiency in income tax for Dorothy Showell in the amount of $3,392.25. The cases were then brought to this Court by separate Petitions for Review which were filed on March 9, 1955 (R. No. 14760 at 29, 121). The jurisdiction of this Court to review the aforesaid decisions of the Tax Court was founded on Sections 7482 and 7483 of the Internal Revenue Code of 1954.

Thereafter, on October 10, 1956, this Court, in a majority opinion written by Judge Chambers, remanded the cases to the Tax Court of the United States for further proceedings on the ground that the findings of fact were not sharp enough or sufficiently definitive. *Showell v. Commissioner,* 9 Cir., 1956, 238 F. 2d 148. Subsequently, on January 31, 1957, the Tax Court filed a memorandum opinion which arrived at the same result, insofar as petitioners' alleged deficiencies were concerned, as it did in its first and regular opinion of December 16, 1954. Since each deficiency, determined by the Tax Court's regular opinion of December 16, 1954, and decisions of January 26, 1955, had been paid by petitioners after January 26, 1955, the Tax Court, on May 27, 1957, entered decisions that there were no deficiencies due from or overpayments due to petitioners for 1949 (R. No. 15710 at 28, 29). The cases were then brought to this Court by separate Pe-

titions for Review which were filed on July 11, 1957 (R. No. 15710 at 29-34). The jurisdiction of this Court to review the decisions of the Tax Court of May 27, 1957, is founded on Sections 7482 and 7483 of the Internal Revenue Code of 1954.

STATEMENT OF THE CASE AND QUESTIONS PRESENTED

Instead of asserting deficiencies on the basis of either the bank deposits or net worth and disbursements methods, the Commissioner relied wholly on the correctness and veracity of petitioners' own permanent record, in evidence as Exhibit 3, as the sole basis of his deficiency notices (R. No. 14760 at 45). This fact is revealed by the testimony of the examining agent, U. S. Internal Revenue Agent H. L. Mende, who testified on direct examination as follows:

> "Q. Mr. Mende, is the Exhibit 3, which is now in evidence, the only source of the amount of $11,281.83 set forth in the notices of deficiency?
>
> A. To the best of my knowledge and belief, it is." (R. No. 14760 at 45).

Thus, it was found that all of the entries appearing in the "Gain" column of Exhibit 3 were accepted by the Commissioner while all, except for entries representing certain expense items, in the "Loss" column were rejected (R. No. 14760 at 16-18, 51). Such action was taken by the Commissioner in spite of the fact that the entries made in both the "Gain" and "Loss" columns were net gains or net losses (R. No. 14760 at 15). That is, the total of all losing bets was deducted from the total of all winning bets and the resulting net gain or net loss entered on Exhibit 3 under the "Gain" column if a net gain, or the "Loss" column if a net loss (R. No. 14760 at 14, 15). In explaining the above procedure used to determine petitioners' correct income, the examining agent testified as follows:

> "Q. Were any of the gains or losses used in computing the 'Gain' column substantiated?

A. No more than the losses.

Q. In other words, is it correct to say that you accepted all of the amounts in the 'Gain' column and rejected all the amounts in the 'Loss' column?

A. Except those expenses I told you about." (R. No. 14760 at 51).

From the above material, it is clear that the Commissioner accepted both the method of accounting regularly employed by petitioners (R. No. 14760 at 104) and the truthfulness and accuracy of his permanent record (Exhibit 3) for the purpose of computing and asserting deficiencies in tax. However, it is also equally clear that the Commissioner rejected the same method of accounting, and the accuracy and truthfulness of the same record or piece of paper (Exhibit 3) when any entries resulted in the conclusion that no additional income had been realized.

No testimony or evidence of any kind was introduced by the Commissioner at the trial of this cause except for the original 1949 federal income tax return of each petitioner. In fact, the Commissioner's counsel frankly stated in the opening statement:

" . . . You may wonder why we are here in such a case, but this is somewhat of a test case to see how far a person engaged in the betting and booking business may operate without keeping the usual records which are kept by a merchant and a man in business . . . " (R. No. 14760 at 39).

The Tax Court, in its first opinion of December 16, 1954, 23 T. C. 495, and in its second opinion of January 31, 1957, sustained the Commissioner's action in substance by holding that the "Loss" column entries were reliable only to the extent of $3,000 more than the four expense item entries. The Tax Court did not state which of the entries were reliable and which were unreliable, or why the "Loss" column entries were reliable only $3,000 worth. The effect of this finding was to disregard a total of $20,144.77 in record entries appearing in the "Loss" column (R. No. 14760 at 17, 18), and to find that petitioners sustained additional income of $19,563.66.

Later when the cases came before this Court, it was decided by the majority, in an opinion written by Judge Chambers, that "the only thing that justifies the conclusions reached by the Commissioner or the Tax Court is disbelief or dissatisfaction with the testimony," but "the findings are not sharp enough to tell us this." Thus, the remand to the Tax Court was on the ground that "the findings were not sufficiently definitive."

The first issue before this Court is whether the Tax Court has complied with the remand. The second issue is whether the Tax Court should be reversed in that its decision permitted the Commissioner to determine deficiencies without complying with Section 41 of the 1939 Internal Revenue Code which requires that he adopt a method of accounting. The third issue is whether the decisions are not supported by the evidence, are clearly erroneous, and are not in accordance with law. Finally, there is the issue of whether the Tax Court erred when the trial judge refused to admit certain evidence concerning petitioners' net worth and disbursements for 1949 in view of its finding of fact that petitioners' records were inadequate.

The present appeal is in the nature of a rehearing. *McGah v. Commissioner,* 9 Cir. 1954, 210 F. 2d 769.

SPECIFICATION OF ERRORS RELIED ON

1. The Tax Court erred in that its findings did not comply with the opinion of the United States Court of Appeals for the Ninth Circuit remanding the case for more definitive findings of facts.

2. The Tax Court erred in finding as fact that petitioner did not keep regular, adequate and permanent books and records of his wagering transactions while at the same time sustaining respondent's determination of income which was not based on any method of reconstructing income as required by Section 41 of the Internal Revenue Code of 1939.

3. The Tax Court erred in refusing to allow petitioner to introduce evidence respecting his net worth and disbursements in

view of its finding of fact that he did not keep regular, adequate and permanent books and records.

4. The Tax Court erred in treating as evidence the general presumption of correctness which attaches to the Commissioner's determination.

5. The Tax Court erred in that its decision is not supported by the evidence, is clearly erroneous, and is not in accordance with law.

ARGUMENT

Rather than bolt directly into the issues raised by the Tax Court's second decision in this case (16 TCM 103, Dec. 22, 239 (M), T.C. Memo. 1957-22) petitioners ask the Court if it will first consider the framework of reference in which this second appeal is being heard.

When this case was tried before Judge Withey of the Tax Court, the Commissioner made an opening statement concerning the nature of the issue before the Tax Court:

> ". . . You may wonder why we are here in such a case, but this is somewhat of a test case to see how far a person engaged in the betting and booking business may operate without keeping the usual records which are kept by a merchant and a man in business, . . ."(R. No. 14760 at 39).

> ". . . *it does present the question as to how much the* taxpayer must keep and record his losses in such cases." (R. No. 14760 at 40). (Emphasis supplied).

In like vein, the U. S. Internal Revenue Agent who worked the case testified in explaining why he rejected the items appearing in the "Loss" column that:

> ". . . *they wanted to test it out whether proper records should be kept in the case.*" (R. No. 14760 at 51). (Emphasis supplied).

Later in his two paragraph brief filed with the Tax Court, re-

spondent contended that the deficiencies should be sustained because:

> ". . . petitioner's records of wagering transactions are not susceptible of investigation. It is impossible to audit the meager records kept by petitioner. The *respondent cannot determine his correct tax liability from the records furnished by the petitioners.*" (R. No. 15710 at 20-21). (Emphasis supplied.

From the foregoing materials it is apparent that the Commissioner of Internal Revenue asked the Tax Court to sustain the proposition that although "respondent cannot determine his (the taxpayer's) correct tax liability from the records furnished by the petitioner", deficiencies in income tax (which of necessity assume some correct tax), based upon one-half of those same records, should be sustained. No statutory or case law authority was cited by respondent except the case of *Johnson v. United States,* 1941, 94 Ct. Cls. 345, 39 Fed. Supp. 103, wherein the taxpayer kept no records at all of income or expenditures.

On the other hand, petitioners contended that, on the record before the Tax Court, they had carried their burden of proof and were entitled to judgment to the effect that petitioners had not sustained additional income in 1949. It was pointed out that the burden of proof had been carried by:

(1) The introduction in evidence of Exhibit 3.

(2) The uncontradicted testimony of petitioner Showell and of Houston L. Walsh as to the manner and accuracy of its preparation.

(3) Respondent's action in relying on Exhibit 3 as the sole basis of his notice of deficiency.

(4) The evidence concerning petitioners' net worth and disbursements for 1949.

Thereafter, the majority of the Tax Court ruled that:

> ". . . we cannot accept the evidence as *conclusively* proving

the full amount of the claimed losses. . ." (R. No. 14760 at 20) (Emphasis supplied).

and found as ultimate fact that petitioners realized additional income of $19,563.66 during 1949. However, the Tax Court's first decision and opinion raised certain questions which petitioners wished to submit to this Court by means of an appeal. Some of these questions were:

(1) Was the majority opinion correct in its interpretation of the burden of proof rule when it required that the latter be carried by *conclusive* proof?

(2) Was the ultimate finding of fact respecting $19,563.66 of additional income not contrary to the findings of fact concerning the precise manner in which Showell, with the help of Houston L. Walsh, transferred the amounts from daily records to Exhibit 3?

(3) Was the Tax Court in error when it denied petitioners the right to introduce certain net worth and disbursements evidence as some proof that petitioners realized no additional income in a case where the Commissioner had in effect refused to accept part of petitioners records?

Subsequently, the first appeal to this Court was heard. During that appeal, petitioners hoped they could persuade the Court that the Tax Court's decision against petitioners was preordained so long as it adopted what petitioners believed were the incorrect premises that (1) the case was one involving the disallowance of specifically claimed losses rather than the adequacy of petitioners' permanent record, as respondent had stated, and (2) that a taxpayer must prove those losses *conclusively*. The reasons such a decision would be inevitable were that premise No. 1 avoided the fact that the Commissioner's deficiency was itself based solely on the accuracy of one-half of petitioner's record (Exhibit 3) while premise No. 2 imposed a burden of proof no taxpayer can carry.

It was in this context that the majority and minority opinions were written by Judges Chambers and Pope respectively. *Showell v. Commissioner,* 9 Cir., 1956, 238 F. 2d 148.

I

The Tax Court's Memorandum Opinion of January 31, 1957, Failed To Comply With This Court's Remand.

When Judge Chambers wrote this Court's majority opinion in *Showell v. Commissioner,* 9 Cir., 1956, 238 F. 2d 148 he set forth the entire 1496 words which had appeared under the designation "Findings of Fact" in the Tax Court's first and officially published opinion herein. *Showell v. Commissioner,* 1954, 23 TC 495. Among those findings of fact will be found the following:

> "At the end of the day, if a baseball or basketball game was involved, or at the end of the week if a football game was involved, the petitioner would read to Houston L. Walsh, who *shared* an office with petitioner, the amounts entered on the slips of paper and the tally sheets to be paid to winning bettors and Walsh added them on an adding machine. A similar procedure was followed for determining the amount of the losing bets. When the *totals* of both were obtained, a similar procedure was followed *with Walsh reading* to petitioner *from the slips of paper and tally sheets* and petitioner operating the adding machine. After the foregoing procedures had been gone through, entries, *as follows*, were made on a sheet of columnar paper, entitled 'Sports'—1949' and submitted in evidence as petitioner's Exhibit 3. If the total of the amounts of the bets by losing bettors exceeded the total of the amounts to be paid to winning bettors, *the amount of the excess was entered* on Exhibit 3 in a column under the heading 'Gain'. If the total of the amounts to be paid winning bettors exceeded the total of the amounts of the bets by losing bettors, *the excess was entered* on Exhibit 3 in a column under the heading 'Loss'." (R. No. 14760 at 14, 15) (Emphasis supplied).

Nevertheless, although the above findings of fact found that the losses incurred were recorded on Exhibit 3, the Tax Court's decision disallowed $19,563.66 of the entries under the Loss column.

Therefore, later in the majority opinion, Judge Chambers said:

> "The only thing that justifies the conclusions reached by the Commissioner or the Tax Court is disbelief or dissatisfaction with the testimony. Yet the findings are not sharp enough to tell us this. . . .
>
> "The remand therefore will be on the ground that *the findings* were not sufficiently definitive." (Emphasis supplied).

Thereafter, the Tax Court in an unofficially published memorandum opinion (16 TCM 103, Dec. 22, 239 (M), T.C. Memo. 1957-22) substituted the following 123 words under the designation "Findings of Fact".

> "The petitioners are husband and wife and filed their separate income tax returns for 1949, prepared on the community basis, with the collector for the district of Arizona."
>
> "In their returns for 1949 the petitioners reported income from interest, from a partnership, and rental income from a building. No income was reported from, *or loss deducted* with respect to, any wagering operations."
>
> "During 1949 Jack Showell, sometimes referred to as the petitioner, received money from booking bets on baseball, football and basketball games. No receipts or tickets were given for money placed on bets. *The petitioner did not keep regular, adequate and permanent books and records of his wagering transactions.*"
>
> "Petitioner had unreported income from wagering operations in 1949 amounting to $19,563.55." (R. No. 15710 at 23). (Emphasis supplied).

Are these fiindings sharp enough to tell this Court that the Tax Court disbelieved or was dissatisfied with *the testimony?* Petitioners ask how they could be in view of the complete absence of any finding of fact concerning whether or not the Tax Court disbelieved or was dissatisfied with the testimony of petitioner and the witness Houston L. Walsh. In view of Judge Chambers' statement that the *only* justification for the conclusion reached by

the Tax Court is disbelief or dissatisfaction with *the testimony* and that the *findings* do not so state, how can the lack of such a finding of fact, after remand, be explained? Petitioners submit that this is no oversight by the Tax Court but is a conscious and determined refusal to make any findings of fact that it did not believe Showell and Houston L. Walsh. The reasons for such refusal are:

(1) The Tax Court judge who wrote the memorandum opinion of Januray 31, 1957, who also spoke for the majority in the regular opinion of December 16, 1954, did not observe the demeanor of the witnesses.

(2) It was the testimony of petitioner Showell and Houston L. Walsh which was the basis of nearly every finding of fact set forth in the Tax Court's first regular opinion of December 16, 1954, found at 23 TC 495.

(3) Exhibit 3, a permanent record maintained by petitioner Showell with the assistance of Mr. Walsh, was the sole basis of the Commissioner's statutory notice of deficiency.

(4) Such a finding of fact would be contrary to a request for a finding of fact filed with the Tax Court by the Commissioner (Requested Finding of Fact No. 3, R. No. 15710 at 19).

(5) The Trial judge's dissenting opinion of December 16, 1954, showed that credibility of the witnesses was not relevant insofar as he was concerned since it was his conclusion that it was impossible for petitioners to carry the burden of proof without the individual bet slips.

No doubt the above reasons explain why the Tax Court attempted to skirt around its dilemma by the statement found under the designation "Opinion" rather than "Findings of Fact" that:

> "On this *record* we are unconvinced that petitioner suffered wagering losses to the extent claimed." (R. No. 15710 at 26). (Emphasis supplied).

However, even if such a statement in the opinion could qualify

as a finding of fact, does it constitute a *sharp* statement that the Tax Court disbelieved or was dissatisfied with *the testimony?* There are important differences between a statement that the court is *unconvinced* with *the record* and the statement that the court disbelieves or is dissatisfied with *the testimony,* particularly in view of the background of this case. The statement that the Tax Court is unconvinced on the record may simply be another way of saying that petitioners did not offer conclusive proof and therefore the Tax Court is unconvinced on the record. For the Tax Court to offer in its opinion the very ambiguous statement that it was unconvinced on the *record,* in the face of Judge Chambers' clear statements that conclusive proof is not necessary and that the *only* justification for the conclusions reached is disbelief or dissatisfaction with *the testimony* which the *findings* are not sharp enough to tell, is tantamount to a statement by the Tax Court that it will not find that it disbelieved or was dissatisfied with the testimony.

Furthermore, how could the Tax Court, as a practical matter, find that it disbelieved the testimony of the witnesses and at the same time allow $3,000.00 more of the entries appearing in the 'Loss' column of Exhibit 3? How does the Tax Court believe the witnesses only $3,000.00 worth? What testimony with relation to what entries in the Loss column of Exhibit 3 was believable and satisfactory and what testimony with relation to what entries in the Loss column of Exhibit 3 was unbelievable and unsatisfactory? If the testimony was unsatisfactory and not believable, it was so with respect to all of Exhibit 3.

When the Court examines findings of fact requested by respondent and petitioners (R. No. 15710 at 7-10, 19), it will be seen why the Tax Court could not find that it disbelieved or was dissatisfied with the testimony concerning Exhibit 3. Should such a finding be made, it would constitute a refusal to find facts about which the parties had no dispute. For instance, the Commissioner requested the Tax Court to find as fact that:

"Petitioner's method of accounting for the results of wagering transactions was to record on slips of paper the essential facts of each wager, to add up the day's wins and losses and *record* the excess only of gains or losses opposite the date. (Tr. 28-33). The original slips of paper and other sheets were destroyed (Tr. 32, 59), and the only permanent record retained was *the entry* of such final results of each day's betting (Ex. 3)." (R. No. 15710 at 19). (Emphasis supplied).

Surely if the party asserting the tax deficiencies against petitioners did not dispute the fact that daily net wins and losses were recorded on Exhibit 3, it is not difficult to see why the Tax Court is reluctant to find as fact that it disbelieved or was dissatisfied with the testimony concerning those entries. All it could say, in its opinion, was that it was unconvinced with the *record.* But what part of the record? Wherein did petitioners fail? Would the Tax Court have ruled otherwise if the individual bet slips had been placed in evidence? How can a United States Court of Appeals determine whether this dissatisfaction with the record (an all inclusive term) was due to an adoption of the rule of law that conclusive proof is required or was based on disbelief of testimony concerning Exhibit 3 which even the respondent has not disputed? Also such a finding would violate the Tax Court's own rules of practice.

Rule 35 (d) (3) of the Rules of Practice of the Tax Court of the United States provides:

"The party having the burden of proof shall set forth complete statements of the facts based upon the evidence. Each statement shall be numbered, shall be complete in itself, and shall consist of a concise statement of the essential fact and not a discussion or argument relating to the evidence or the law. Reference to the pages of the transcript or the exhibits relied upon in support thereof shall be inserted after each separate statement.

"If the other party disagrees with *any* or all of the statements of fact, he *shall set forth each correction* which he believes the evidence requires and shall give the same numbers to his state-

ments of fact as appear in his opponent's brief. His statement of fact shall be set forth in accordance with the requirements above designated." (Emphasis supplied).

In this case the Commissioner not only failed to disagree with petitioners' requested findings of fact concerning Exhibit 3, but he actually asked for the same finding. (R. No. 15710 at 7-10, 19). Consequently, how could the Tax Court find that it disbelieved or was dissatisfied with the testimony concerning the method and accuracy by which Exhibit 3 was maintained? All it could do was talk in its opinion in terms of generalities saying it was unconvinced with the *record* rather than find as fact it disbelieved or was dissatisfied with the testimony.

Next, are the above 123 words more "definitive" than findings of fact which consumed 1496 words? Petitioners' counsel are fully aware of the important distinction between quantity and quality, but is it reasonable to conclude that these particular 123 words are more definitive and sharper than the 1496 found in the Tax Court's first regular opinion? The only method of securing an answer is to examine each finding separately and then in conjunction with all of the findings.

To begin with, what do the first five sentences supply in the way of definitiveness and sharpness which was lacking in the Tax Court's findings of fact in its first decision? These five sentences constitute a verbatim reproduction of the first five sentences of the Tax Court's first findings of fact in its first decision (R. No. 14760 at 12). The sixth sentence states that petitioner did not keep regular, adequate and permanent books and records of his wagering transactions while the seventh and final sentence is merely a paraphrase of the ultimate finding of fact in the first decision which provided that petitioner sustained additional wagering losses of $3,000.00 over those allowed by respodent.

In other words, until the final sentence of the findings is uttered, there is not a single specific or particular finding of fact in support thereof. It is a bolt out of the blue, which, if permitted to

stand, makes an opinion an unnecessary appendage. It is the kind of "finding of fact" which is a mixed conclusion of ultimate fact and law arbitrarily thrown at the taxpayers to make of as they will. The Tax Court has done this sort of thing before and has been continually reversed. The Tax Court must find the facts upon which its findings of unreported income is based. *Timmons v. Commissioner,* 4 Cir., 1952, 198 F. 2d 141. The Tax Court may not, as it has here, find only that petitioner's losses were less than those claimed. *Mesi v. Commissioner,* 7 Cir., 1957, 242 F. 2d 558. Such "findings of fact" neither comply with the substance nor the spirit of the statutory requirement that the Tax Court *shall* report in writing *all* its *findings of fact.* 26 U.S.C.A. § 7459 (b). Certainly it affords a United States Court of Appeals no opportunity to measure and evaluate the decision against the basic findings of fact upon which it rests. In fact, the above 123 words of findings of fact "supporting" the Tax Court's second decision are one step and only a very few words away from a ruling which simply says: "The taxpayer loses. Sorry." Also, what happened to the findings of fact, consuming 1496 words, set forth in the first decision, which detailed the precise manner in which Exhibit 3 was maintained? Can those facts, designated by the Tax Court as findings of fact in its first opinion, evaporate or merely disappear into some limbo for unwanted findings of fact? They can still be found and read at 23 TC 495. The Tax Court has not yet stated that it repudiated those earlier findings of fact concerning Exhibit 3. All it says, and that is said in the opinion rather than in the findings of fact, is that it is unconvinced on the *record.*

If it is held that the findings of fact set forth by the Tax Court in response to this Court's opinion are sufficiently definitive, then it is submitted that there was little reason to remand the case because the same ultimate finding that Jack Showell realized $19,563.66 of additional income, along with the other findings now found in the memorandum opinion, were all found in the Tax Court's first opinion. It is true that in the first decision the Tax Court's ultimate findings stated that wagering losses of $3,-

000.00 more than those allowed by the Commissioner were sustained. However, since the statutory notices of deficiency addressed to each petitioner asserted additional income of $22,-563.66, an ultimate finding of fact that petitioners sustained $19,-563.66 of additional income is simply another way of saying that petitioners were entitled to losses of $3,000.00 more than those allowed by the Commissioner who had claimed $22,563.66 of additional income. It is a matter of arithmetic: $22,563.66 minus $3,000.00 is $19,563.66.

Petitioners submit that the 123 word findings of fact set forth by the Tax Court in support of its second decision are not sharper or more definitive when measured by the standards of either quantity or quality. If they are, then George Orwell's notion that *less is more* is not so unreal after all. In any event, it is doubtful that a contention could be sustained that this Court's majority opinion called for no findings of fact except the ultimate findings of fact in view of the complaint it had previously registered concerning the Tax Court's failure to voluntarily comply with Rule 52 of the Federal Rules of Civil Procedure. *Gillette's Estate v. Commissioner,* 9 Cir., 1950, 182 F. 2d 1010.

Whether the Tax Court's first decision can be reaffirmed merely by rearranging its opinion and placing its original findings of fact under the designation "Opinion" in the second memorandum opinion or eliminating findings of fact inconsistent with the decision is a matter which petitoners leave to this Court.

II

The Tax Court Erred In Sustaining A Determination Of Income Not Determined In Accordance With Any Method Of Accounting.

There are other reasons why the Tax Court's decision should be reversed. These arise as a result of the new finding of fact, found in the sixth sentence, that "the petitioner did not keep regular, adequate and permanent books and records of his wagering transactions." (R. No. 15710 at 23). Accepting for purposes of

argument that this finding is not clearly erroneous or mistaken, what is its legal effect? To answer the question, it is necessary to turn to Section 41 of the Internal Revenue Code of 1939 which provides that:

> "Sec. 41. The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with *such method* as in the opinion of the Commissioner *does clearly reect the income. . . .* " (Emphasis supplied).

The above language "if the method employed does not clearly reflect the income" has been interpreted by the courts, including the Tax Court, to comprehend the situation where a taxpayer's records are inadequate. Thus, 2 CCH 1953 Fed. Tax Rep. ¶ 386.011 states:

> "011. Reconstruction of income. — Where a taxpayer keeps no books or records *or his records are inadequate,* the Commissioner may under authority of Code Sec. 41 compute his income in accordance with *such method* as in the opinion of the Commissioner will clearly reflect the taxpayer's income." (Emphasis supplied).

The courts have further held that the method adopted by the Commissioner must be reasonable. *Bradstreet Co. of Maine v. Commissioner,* 1 Cir., 1933, 65 F. 2d 943; *Schira v. Commissioner,* 6 Cir., 1957, 240 F. 2d 672; 2 Mertens, Law of Federal Income Taxation, Cum. Supp. p. 30, 31. The method adopted must properly reflect the taxpayer's income. *A & A Tool & Supply Co. v. Commissioner,* 10 Cir., 1950, 182 F. 2d 300, 302. In the *Bradstreet* case, *supra,* the Court said: "the burden to adopt *a method* that will clearly reflect the income is on the Commissioner equally as well as on the taxpayer." And in *H. T. Rainwater,* 1954, 23 TC 450, the Tax Court itself said:

> "Of course, the destruction of records is a factor that may be taken into account in various circumstances such as the determination of fraud, and it may justify the Commissioner in using *some reasonable method* of reconstructing a taxpayer's income, with the burden upon the taxpayer to show that the Commissioner is in error. . . ."

Some of the methods approved by the courts when the books and records are inadequate or non-existent are (1) bank deposits, (2) percentage basis, and (3) net worth and disbursements. 2 Mertens, Law of Federal Income Taxation, §12.12.

Here there was no method used at all. The Commissioner simply extracted the total of the figures appearing under the Gain column of Exhibit 3 less 4 entries and adopted the sum as net income from wagering, while ignoring the companion figures appearing under the column entitled Loss. Is this a *method* of determining income? Is it a method that *clearly* reflects income? Petitioners submit that it is no method at all much less one which clearly reflects income. The word "method' according to the 1951 edition of the Thorndike-Barnhart Dictionary means "system in doing things; order in thinking." Two of the synonyms given are "plan" and "design." Yet where is the system or order when the Commissioner determines income by picking and choosing the entries in a taxpayer's records which reflect income while at the same time ignoring each entry which reflects a lesser income. Surely it cannot be said that there were no methods available to the Commissioner to ascertain Jack Showell's net income if he was dissatisfied with the adequacy of his books and records. The net worth and disbursements method has been used in such cases along with the bank deposits and percentage basis. As the Tax Court itself stated in the similar and later case of *Ross v. Commissioner,* 15 TCM 23; Dec. 21, 511 (M); T. C. Memo. 1956-5:

> "Respondent's statutory notice determines no fraud, mathematical inaccuracy, or *specific* discrepancy with respect to the 'outs'. This position is, in substance, that there is no practical way in which he can verify by audit the amount of the 'outs'

> because petitioners did not require receipts for 'outs' or obtain the names and addresses of winning bettors. We doubt whether such data would have been of material assistance in an audit because it is unlikely that true names and addresses would have been furnished to bookmakers. We recognize the difficulty of an effective audit, however, we do not think the solution lies in the effort to apply an unrealistic formula. Other techniques, such as the determination of income by the net worth increase method, have been developed which have been quite effective in ferreting out unreported income where the usual auditing methods are inadequate. No such method has been availed of in the instant case."

Likewise, in the instant case, the net worth and disbursements method, as well as any other method which would clearly reflect income, was available to the Commissioner when he had concluded that the taxpaper's records were inadequate. Yet no method was adopted here.

Furthermore, the Tax Court refused to sustain the Commissioner in two other cases nearly identical to the case at bar stating that such a reasonable *method* of determining income was lacking. *Ross v. Commissioner, supra,* and *Snyder v. Commissioner,* 14 TCM 1126, Dec. 21, 310 (M), T.C. Memo. 1955-293. In each of these cases and in the *Rainwater* case, *supra,* the taxpayer was a bookmaker whose books and records were held inadequate. In each case the Commissioner disregarded the net loss shown on the taxpayer's permanent record and limited them to a percentage of the gross intake currently being paid out by race tracks. In each case the Tax Court held that the reconstruction of the income was arbitrary on the ground that a bookmaker's loss percentage was not likely to correspond with that of a race track. Yet in the case at bar there was no formula of any kind used, no utilization of any method of determining income, and yet the Tax Court sustained the Commissioner. Thus, the Commissioner has found an ideal solution to the problem which is not to adopt any method at all. Do not use percentages, do not use net worth and disbursements or bank deposits, but simply disregard certain en-

tries in a permanent record. In this case the Tax Court is saying that although the books and records are inadequate in its opinion, the Commissioner may extract those figures appearing under the Gain column and reject everything else. If allowing losses equal to a percentage based on race track losses is arbitrary, how can a pure and unadulterated guess both by the Commissioner and the Tax Court be reasonable? When the Commissioner uses a method of determining income such as the net worth and disbursements method he cannot make an arbitrary guess as to any of the net worth components. *Thomas v. Commissioner,* 1 Cir., 1956, 232 F. 2d 520. If not, then how can the Commissioner or the Tax Court be permitted to guess when no method of any kind was used?

Nor is the lack of the requisite "method" alleviated by the argument advanced by the Tax Court in its first opinion that the "Gain" figures were admissions against interest. The requisite "method" of accounting called for by Section 41 cannot be created or brought into existence simply by invoking a legal rule of evidence, even assuming it is correct in its application. This is because the statute itself requires a "method" if the Commissioner decides the books are inadequate. Thus, once the Tax Court finds as fact, as it has in this second opinion, that petitioner's books and records were inadequate, the admissions against interest argument as applied to the "Gain" column becomes irrelevant. In short, the legal concept of admissions against interest, even if the Tax Court had correctly applied it, is not a method of determining income as required by Section 41.

If the Commissioner had adopted the net worth and disbursements method or any other method for that matter, petitioners could submit evidence in reply. However, in this case the Commissioner and the Tax Court used no method at all. Instead the Commissioner relied entirely on the legal presumption of prima facie correctness of his determination which evaporated at the trial when contrary evidence was placed in the record. *J. M. Perry Co.*

v. Commissioner, 9 Cir., 1941, 120 F. 2d 123; 9 Mertens, Law of Federal Income Taxation, § 50.71 (1943).

Under Section 41 of the 1939 Internal Revenue Code, the Commissioner may bypass or ignore a taxpayer's books and records which he deems lacking or inadequate, but he must then adopt a *method* of reconstructing income which is reasonable and clearly reflects income. Here the Commissioner cannot have it both ways. He cannot conclude that a taxpayer's records are inadequate, and still maintain that he is not required to adopt any method of ascertaining income. To rule otherwise means that there is no way of overcoming a deficiency determined after the Commissioner rejects a taxpaper's books and records so long as the Commissioner fails to adopt any method of reconstructing income.

Furthermore, even if it were accepted that the means by which the Commissioner ascertained net income in this case could qualify as a method, is it a method which clearly reflects the taxpayer's income as required by Section 41? The comments of the Tax Court and Judge Chambers both reflect that neither this Court nor the Tax Court thought any method was used. Judge Chambers indicated that the determination may be "half arbitrary" or "half intelligent," (*Showell v. Commissioner,* 9 Cir., 1956, 238 F. 2d 148, 152), while the Tax Court called it "speculative" (*Showell v. Commissioner,* 16 TCM 103, 105, Dec. 22, 239 (M), T. C. Memo. 1957-22). Why is this necessary when Section 41 provides methods of ascertaining income, approved by the courts, if the Commissioner refuses to accept a taxpayer's books and records. None of these methods, including the net worth and disbursements method, was even attempted by the Commissioner in this case. Petitioners submit that the fair inference to be drawn is that none of these methods resulted in deficiencies. If the Commissioner rejects the adequacy of a taxpayer's records, as was done here, does it make sense that he may base a deficiency solely upon those same records, or must he, as Section 41 requires, adopt a method of determining income? Of course the Commissioner can adopt any procedure he desires so long as he relies upon the legal pre-

sumption of correctness which attaches to his deficiency. But the question is what is left after the presumption evaporates, as it did here?

Petitioners submit that the law of Federal income taxation, as developed by the courts through the interpretation given Section 41 of the 1939 Internal Revenue Code, makes it unnecessary for the Tax Court or a United States Court of Appeals to approve a determination by the Commissioner which is "half arbitrary, half intelligent" or "speculative." Nor is it any answer to cite *Cohan v. Commissioner,* 2 Cir., 1930, 39 F. 2d 540 as did the Tax Court in its second memorandum opinion. *Showell v. Commissioner,* 16 TCM 103, Dec. 22, 239 (M), T.C. Memo. 1957-22.

Cohan v. Commissioner, supra, is not authority for the proposition that the Tax Court may sustain a determination which by its own words is "speculative." In that case George M. Cohan *kept no record* at all of the amounts he spent for entertainment. The Tax Court therefore refused to allow Mr. Cohan any part of the sums spent, as a deduction, on the ground that it was impossible to tell how much he had in fact spent. The United States Court of Appeals for the Second Circuit held that the Board was *inconsistent* when it said on the one hand that something was spent, but on the other hand allowed nothing, and therefore it ordered the Board to reach some allowance. But is this the situation in the case at bar? In the *Cohan* case, *supra,* the taxpayer maintained no records. In the case before the Court, petitioner Showell maintained a daily permanent record, half of which served as the sole basis of the Commissioner's deficiency determination. In the *Cohan* case, *supra,* the Court of Appeals held the Board was being inconsistent when it said something was spent, but allowed nothing. Is the Tax Court not inconstistent here when it finds as fact that petitioner's books and records of wagering transactions were irregular and inadequate while at the same time sustaining a deficiency based on the entries found in those same inadequate and irregular books and records?

For the foregoing reasons, petitioners contend that the Tax Court was in error when, on the one hand, it found as fact that petitioner's records were inadequate, while, on the other hand, it sustained a determination of income based on no method of any kind. Where the Commissioner's determination is held to be arbitrary, the matter may be remanded to the Tax Court. *Marx v. Commissioner,* 1 Cir., 1950, 179 F. 2d 938. *Helvering v. Taylor,* 1935, 293 U. S. 507, 55 S. Ct. 287, 79 L. Ed. 623.

III

The Tax Court Erred When It Found That Petitioners Did Not Keep Regular, Adequate, and Permanent Books and Records Of Wagering Transactions.

In *Bechelli v. Hofferbert,* D. C. Md., 1953, 111 Fed. Supp. 631, the facts reflect that the Commissioner of Internal Revenue had determined that certain books and records maintained by restaurant operators were inadequate. The method of keeping books was as follows: At the end of each day one of the partners (or at times a chief employee in the business) prepared a written itemized statement showing the cash receipts for the day as taken from the cash register tape and an itemized statement of the expenses paid for the day for supplies for the kitchen and bar. These daily records were then given every two or three days to the partnership's bookkeeper, one Mr. Owens, who was a long time personal friend of each partner and who did the bookkeeping without pay. Mr. Owens recorded the receipts and expenses for each day. The daily sheets were not preserved. The Court held that:

> "The critical test as to the sufficiency of the books on their face is whether they are sufficient to calculate the net income. If they are sufficient in this respect then the simpler the better. *There is no prescribed detail as to just what books or how many must be kept.* The question in each case must be determined on its particular facts and in view of the nature, volume and complexity of the business. Here the books as kept do show day by day receipts and expenses. If the figures are correct the books are sufficient to show the net income." *Bechelli v. Hofferbert, supra* at 633. (Emphasis supplied.)

Applying the same rule to the case at bar, it follows that if the figures are correct, the books are sufficient to show the net income from wagering. Consequently, since there is no evidence of any kind that Exhibit 3 was not maintained accurately or correctly and no finding of fact that the losses did not occur or that Exhibit 3 contained inaccuracies, the record kept by petitioner (Exhibit 3) is adequate.

As was pointed out by the Court in *Ragsdale v. Paschal,* D. C. Ark., 1954, 118 Fed. Supp. 280, 284:

> "Section 41 of the Internal Revenue Code, 53 Stat. 24, Title 26 USCA 41, provides in part as follows:
>
> 'The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the commissioner does clearly reflect the income. * * * '
>
> "Therefore if the method of accounting used by the plaintiff was a commonly accepted method and the books were sufficiently accurate and complete for the computation of income for the year 1944, then there would be no justification for the Commissioner attempting to reconstruct plaintiff's net income for that year through any alleged increase in net worth, *or by any other method than from the books and records.* This would be so unless there should be found income from some source which the plaintiff had received and which had not been taken into the books. The source of this income and the amount must be ascertainable with at least reasonable definiteness.
>
> "The *defendants have failed to point out any substantial errors in the books and records kept by the plaintiff,* have failed to point out with any degree of certainty any source from which he received income in 1944 not recorded on his books, *and have failed to meet the burden of proving with reasonable clarity the amount of that income.* The agents have stated several possi-

bilities or assumptions, but *neither possibilities or assumptions can take the place of evidence,* and those relied on here do not meet the requirements of the law." (Emphasis supplied.)

The language set forth above is equally applicable here. The Commissioner has not pointed out any errors in petitioner's books and records, much less substantial errors, and has certainly failed to meet the burden of proving with reasonable clarity the amount of that income. Here too there was nothing offered by respondent except possibilities and assumptions.

Finally petitioners ask how a United States Court of Appeals can review or sustain a finding of fact that books and records are inadequate when the Tax Court made no findings of fact as to what records were maintained. How does one review a finding that something is inadequate (a qualitative conclusion) when he is not told in the findings of fact what was kept in the way of books and records?

IV

The Tax Court Decision That Petitioners Sustained Additional Income Of $19,563.66 Is Clearly Erroneous Since It Is Not Supported By The Evidence.

The finding of fact and decision by the Tax Court that petitioners sustained additional income of $19,563.66 is not supported by the evidence and therefore is clearly erroneous (*Wright-Bernet, Inc. v. Commissioner,* 6 Cir., 1949, 172 F. 2d 343) and should be set aside (*Hatch's Estate v. Commissioner,* 9 Cir., 1952, 198 F. 2d 416). A reading of the record below shows that there is no evidence to support the subject finding, and that the Tax Court has erroneously treated an evaporated legal presumption of prima facie correctness attaching to the Commissioner's determination as evidence. In fact, there appears to be no dispute between this Court's majority and minority opinions on this point. Thus, Judge Chambers stated at page 152:

" . . . In a way this may be partly explained by the fact that all testimony was presented by the Showells and on the face of

it *there are no* substantial contradictions anywhere." (Emphasis supplied.)

And Judge Pope said in his opinion at page 154 with respect to Exhibit 3:

> " . . . The findings detail the precise manner in which petitioner, with the aid of the witness Walsh, transferred the amounts from the daily sheets to Exhibit 3. *There is not an iota of evidence that this was not done correctly or accurately* and there is no finding either that the losses did not occur or that the method of computing and transferring them to Exhibit 3 contained any inaccuracies." (Emphasis supplied.)

Therefore, in view of this Court's holding in *Grace Bros. v. Commissioner,* 9 Cir., 1949, 173 F. 2d 170, that uncontradicted testimony *must* be followed, it is clear that the Tax Court's finding is clearly erroneous. This is a case in which both Judge Chambers and Judge Pope concluded there were no contradictions in the testimony or evidence offered by petitioners. Thus, unless the exception set forth in the *Grace Bros.* case, *supra,* at page 174, applies, the testimony must be followed. In that opinion this Court held:

> "It is axiomatic that uncontradicted testimony must be followed. Chesapeake and Ohio Railway Company v. Martin, 1931, 283 U.S. 209, 216, 217, 51S. Ct. 453, 75 L. Ed. 983; San Francisco Association for the Blind v. Industrial Aid for the Blind, 8 Cir., 1946, 152 F. 2d 532, 536; Foran v. Commissioner, 5 Cir., 1948, 165 F. 2d 705. The *only* exception to the rule occurs when we are dealing with testimony by witnesses who stand impeached and whose testimony is contradicted by the testimony of others or by physical or other facts actually proved or with testimony which is inherently improbable." (Emphasis supplied).

Since none of the testimony of the witnesses was impeached or inherently improbable, it follows that the testimony *must* be followed. Therefore, for these reasons the finding of fact that petitioners realized $19,563.66 of additional income is clearly erroneous. The rule announced in the *Grace Bros.* case, *supra,* cannot

be avoided by a sentence in the Tax Court's opinion that it was "unconvinced" where the record contains nothing but uncontradicted testimony which is not inherently improbable.

The Commissioner's determination is presumptively correct. However, when this legal presumption is overcome, as it was here, it evaporates or disappears completely and may not be treated as any evidence whatsoever. *Hemphill Schools Inc. v. Commissioner,* 9 Cir., 1943, 137 F. 2d 961, 964.

V

The Tax Court Misapplied The Burden Of Proof Rule In Requiring Petitioners To Submit Conclusive Proof.

In addition to the previous contentions, petitioners also renew each argument set forth in Point I of their opening brief filed in the first appeal to this Court concerning the burden of proof rule.

There it was argued that the Tax Court erred in requiring petitioners to conclusively prove their case. In this Court's opinion denying petitioners' petition for a rehearing en banc, Judge Chambers ruled that "Such is not the law and we have not said it is." However, if the Tax Court's opinions in this case and in subsequent cases clearly show that the Tax Court thinks such is the law, does that not make suspect the ultimate findings of fact in the Tax Court's second opinion here wherein it found, without any specific findings of fact as a foundation, that petitioners had unreported income of $19,563.66? Also, is it not true that the Tax Court erred as to these petitioners when it applied such a rule in determining what the ultimate facts were?

The best evidence that the Tax Court did apply the conclusive proof rule here is found by turning to its own analysis of *Showell v. Commissioner,* 23 TC 495, found in *Simon v. Commissioner,* 14 TCM 1262; Dec. 21, 375 (M); T.C. Memo. 1955-324. There Judge Van Fosson said:

> "The factual situation with which we are here confronted is quite similar to that in the recent case of Jack Showell, 23 T.C.

495, in that here, as there, it appears that the daily records kept of the bets as they came in each day were destroyed each night after checking with the betters and obtaining a balance, and a notation made of the daily winnings or losses. These, it would seem are the notations appearing in the notebook and which were read off to the accountant by petitioner in preparation of the aforementioned exhibits. Further, these notations were apparently the net result of each day's operation, as was the case in Showell.[1] The character of the supporting evidence as to this item is not such as to command full credence. We cannot accept it as accurate and *conclusive.*" (Emphasis supplied).

It is therefore submitted that the Tax Court has erroneously interpreted the burden of proof rule by requiring more than "a preponderance of the evidence" (*Schilling Grain Corp.,* 1927, 8 BTA 1048) such as would reasonably support a verdict for a plaintiff in an ordinary action for the recovery of money (*Burnet v. Niagara Falls Brewing Co.,* 1931, 282 U.S. 648, 51 S. Ct. 262, 75 L. Ed. 594).

VI

The Tax Court Erred In Refusing Evidence Concerning Petitioners' Net Worth And Disbursements In View Of Its Finding That Petitioners' Records Were Inadequate.

Petitioners particularly renew each of the arguments contained in Point II of their opening brief filed in *Showell v. Commissioner,* 9 Cir., 1956, 238 F. 2d 148, insofar as they apply to the Tax Court's refusal to accept evidence concerning petitioners' personal disbursements during 1949. Convincing support for the assignment of this ruling as error is reaffirmed by the new finding of fact in the Tax Court's second opinion wherein it stated that "The petitioner did not keep regular, adequate and permanent books and records of his wagering transactions." If the Tax Court was

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[1] There were important factual differences in the two cases. Here the individual tickets were not destroyed each night, but were kept for several months (R. No. 14760 at 98-99). Also, the totals here were not entered into a notebook by Showell, but were added on an adding machine tape by the witness Walsh and also by Showell (R. No. 14760 at 110-113).

of this opinion, then it committed error in refusing to permit petitioners to complete their submission of evidence via testimony concerning their personal expenditures for 1949. Surely the Tax Court cannot rule that a taxpayer's books and records are inadequate and at the same time refuse evidence, based on the net worth and disbursement method of computing income, as some proof that the books and records were correct or that the taxpayer could not have had the income.

Insofar as the question of a proper foundation is concerned, petitioners ask the Court to consider the following. Judge Chambers, in this Court's opinion of October 10, 1956, *supra* at 153, ruled that a sufficient foundation was not laid for a review of this assignment of error, and stated that ". . . if the only refusal to receive testimony on the net worth method is a refusal to hear about the cost of food, it is doubtful if a case should be reversed." Petitioners submit that the yearly expenditures for food is an indispensible element in proving a taxpayer's income by means of the net worth and disbursements method. The reason, of course, is that proof of an increase or decrease in net worth by itself is meaningless. This is so because personal disbursements (of which food is an important item) are deemed to have been made from cash which passed through the taxpayer's bank account. Consequently, if a taxpayer's cash in the bank at January 1, 1949, amounted to $11,000.00 while the cash in the bank at the close of December 31, 1949, amounted to $1,000.00, there is ostensibly a decrease in net worth of $10,000.00 as to this item. However, if the taxpayer's personal living expenses for 1949 amounted to $5,000.00, this $5,000.00 must be added to the increase or decrease in net worth to arrive at the correct net taxable income for 1949. In short, the net worth method is a misnomer. The proper designation is the net worth *and* disbursements method. Consequently, the petitioners would have failed in their proof had they not offered evidence concerning the cost of food and every other item of personal expenditures made by petitioners during 1949 to prove that the *decrease* in net worth reflected by Exhibit

9 and Jack Showell's testimony was not due to high personal disbursements. For example, a taxpayer's opening and ending net worth could be $100,000 for a given year, and yet he might be found to have realized $50,000.00 of income under the net worth and disbursements method if he spent $10,000.00 for food, $5,000.00 for liquor, $25,000.00 for gifts to friends, $5,000.00 for rent, and $5,000.00 for miscellaneous items such as insurance premiums, shaving soap, gasoline, clothes, etc.

Furthermore, the Tax Court was not unaware of why petitioners were offering the evidence. An exhaustive foundation in the form of questions and answers concerning net worth and disbursements was laid from page 46 through page 59 of the transcript (R. No. 14760 at 75-86). Petitioners' counsel stated to the trial judge just before the objection was sustained

> "Mr. McLane: I am attempting to show total expenses of petitioner during 1949 were such that any difference in net worth could not have been lost in large expenditures during that year." (R. No. 14760 at 85).

Thereafter, respondent's counsel objected on the following grounds and was sustained:

> "Mr. Crouter: I do object, first, it is not the best evidence. The figures could be added up. I offered to stipulate on any documents [2] in this case days before trial and if those will total, it seems to me the figures could have been counted up sometime ago. However, my objection is deeper than that. I do not see how the question of how much is spent on food and automobiles would have any bearing on loss. It is *immaterial* and *irrelevant* and it is not contributing toward the end we are asking about at all."
>
> "The Court: I will sustain his objection." (R. No. 14760 at 85-86) (Emphasis supplied).

Prior to the above exchange, the following conversation occurred with respect to Exhibit 9 itself:

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[2] Documents have nothing to do with testimony concerning a taxpayer's cash expenditures for food, rent, gasoline, entertainment, etc.

"Mr. Crouter: Your Honor, I do *not* have any objection, but it seems irrelative and immaterial unless Counsel connects it up with loss.

"Mr. McLane: It would seem to me appropriate, when respondent can prove a deficiency by the net worth method, and taxpayer can prove it would be impossible by the use of the same method.

"Mr. Crouter: That brings up what I was afraid of. It seems to me that there have been *specific*[3] disallowances of *total* alleged losses or *specific loss* and it is not the net worth approach at all in the usual sense. I am just wondering whether this would add anything to substantiate the loss. It is very remote at best.

"The Court: I will overrule the objection, but by so doing, I am not ruling one way or the other there is a net worth case. I will receive the evidence for what it is worth." (R. No. 14760 at 77) (Emphasis supplied).

From the above language, it is submitted that the trial judge was well aware of the reasons the evidence concerning net worth was being offered, and in fact overruled an earlier objection. Later, however, he sustained an objection as to relevancy and materiality concerning an indsispensible part of net worth evidence. Nor can it be said, in view of the above statements by petitioners' counsel, that the trial judge was not fully appraised of the reasons for which the evidence was being tendered.

Petitioners submit that when the Tax Court sustained the objection to the whole line of testimony based on materiality and relevancy, after the above exchange and previous explanations to the trial judge and after several pages of questions concerning net worth, it would have constituted a useless gesture, and possibly an offensive one to Judge Withey, for petitioners' counsel to ask another question along the same line. Further, the offer of proof

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[3] The record and Tax Court's findings of fact show there was no *specific* disallowance of *total* losses. Instead, the losses sustained on days when operations resulted in a net gain were recognized completely.

as to the particular question concerning the cost of petitioner's family food costs for one month would, standing by itself, add nothing since it was the entire line of testimony which was required to show what petitioner's personal disbursements were during the taxable year.

Petitioners suggest that when the objection made by respondent to the materiality and relevancy of the entire line of questioning was sustained, it could only be concluded that further questions along the same line would be rejected.

SUMMARY

Aside from the previous contentions concerning the Tax Court's decision, after remand by this Court, there are several other miscellaneous but important points upon which petitioners believe some attention should be focused before this appeal is determined.

Certain language from the record of this case lends support to the conclusion that something other than petitioners' correct tax liability was involved when the Commissioner acted in this case. For instance, respondent's opening statement emphasized that:

> " . . . this was somewhat of a test case to see how far a person engaged in the betting and booking business may operate without keeping the usual records which are kept by a merchant and a man in business, . . . so that he (the Commissioner) could *check the return of the man who is alleged to have received such amounts . . .* " (R. No. 14760 at 40) (Emphasis supplied.)

Again, the U. S. Internal Revenue Agent stated in explaining why the "Loss" column entries were ignored:

> " . . . they wanted to test it out whether proper records should be kept in the case." (R. No. 14760 at 51)

These phrases indicate that the method by which petitioner kept his records of betting transactions impeded the efforts by the Commissioner of Internal Revenue to obtain leads which could result in the investigation of other taxpayers who placed bets with petitioner. While such a result probably is a desirable social objective,

what relationship does this investigative objective have to do with the proper determination of petitioner's income which is all that is involved under the Internal Revenue Code? When an operator of a "pin ball" machine pays a winner or a Las Vegas slot machine pays, there is no record of the name and address of the winner obtained by the owner of either machine. Nor is any required by the Internal Revenue Code. Furthermore, as the Tax Court itself said in a similar case, such information would add nothing because the winner would probably supply a fictitious name. *Ross v. Commissioner,* 15 TCM 23, Dec. 21, 511 (M), T.C. Memo. 1956-5. Yet is is the absence of this unnecessary information which the Tax Court says, in this case, was fatal to petitioners even though its absence was not fatal to the sustaining of a notice of deficiency based solely on the same set of facts.

Petitioners believe that the determination of a taxpayer's income tax liability cannot be based on half of his records because those records do not supply investigative leads to the returns of people to whom he paid money. The U. S. Internal Revenue Code is designed to ascertain the correct tax liability of each taxpayer. It should not be used to enforce a moral code to which many Americans do not subscribe. This is particularly true in view of the official recognition accorded to professional gambling by the Internal Revenue Code provision which requires a payment of a special tax by persons engaged in receiving wagers. Section 4411 of the Internal Revenue Code of 1954.

Under the law of Arizona, as announced by its Supreme Court, the booking of bets on football, basketball and baseball games does not constitute illegal conduct. *Engle v. State of Arizona,* 1939, 53 Ariz. 458. There the Supreme Court of Arizona stated that Arizona law does not prohibit gambling per se. The Court's opinion held that a mechanical instrument or devise determining who won or lost was an essential prerequisite to the application of the criminal gaming statute. Yet the practical effect of the Tax Court's decision (an administrative agency of the Executive branch of the Federal government) is to outlaw activity which Ariona's

law permits. This is so because no bookmaker can engage in such activity if he must pay a Federal income tax based on only that half of his records which reflect daily winnings while the other half reflecting daily net losses are rejected. If this is desirable tax policy, it would seem reasonable to conclude that Congress would not have granted petitioners the legal basis upon which gambling losses may offset gambling winnings. Section 23 (h) Internal Revenue Code of 1939.

Next, reference is made to a statement in Judge Chambers' majority opinion which may indicate that this Court's majority was concerned about the nature of one of petitioner's occupations. It was at pages 151 and 152 and is as follows:

> "Of course, the purpose of justice is to ascertain the truth. But how, as a practical matter can a fact trier ever be *quite sure* he has got the truth *in a case like this.*" (Emphasis supplied.)

Petitioners respectfully submit to the Court that the adversary process (plaintiff vs. defendant) presents the factual material to the trial judge upon which a decision is reached. If one of the parties puts on absolutely no evidence and relies exclusively upon a legal presumption of prima facie correctness, should the trial court then decide the case on the record before it or sustain the suspicions of the party who put on no evidence? Petitioners offer the contention that it is neither the duty nor the proper function of a trial judge to decide a case on the basis of anything other than the record before him. The facts in the record are exclusive, and decisions or findings of fact which are not based on that record but on a fear or suspicion by the trial judge that he has not got the truth are bound to make the rules respecting evidence and burdens of proof meaningless. Consequently, petitioners hope the Court will not be concerned by a fear that the fact trier could not be quite sure he has got the truth in a case like this. If a trial judge must always be made quite sure he has the truth before he may find for one party as against the other, it is doubtful if many decisions could be reached or lawyers found to litigate the case. Truth is often a matter of perspective. It is the angle of vision

which matters. If the taxpayer's burden of proof requires that he persuade a trial judge that the latter is quite sure of the facts, independent of the record, it is unlikely that many taxpayers could ever prevail against the Commissioner in the Tax Court. And in this case suppose that the petitioners had maintained the daily individual bet slips? Would the Tax Court be quite sure in that event that petitioners realized no additional income when it has already said that such information would probably add nothing. *Ross v. Commissioner, supra.* The only way the Tax Court could be made quite sure would have required the records and testimony of every individual who placed a bet with petitioner, and even then the question would arise as to whether the Tax Court would have believed those individuals.

Therefore, it is submitted that cases should not be decided upon a trial judge's concept of truth but on the facts before him as adduced at the trial. The purpose of justice, as it is sought by means of the judicial process, is to make sound decisions based on the facts presented at the trial under the rules of evidence and procedure then in force. Any other test is unworkable because it assumes an infallibility which human beings do not possess. No human being could ever be quite sure of the truth in this case or in any other case for that matter. Instead the trial judge must equate truth, if truth is his goal, with the record before him. And in this case the record supports only the petitioners because the Commissioner put nothing in the record either in the form of direct positive evidence or via cross examination.

A third factor which is significant is the Tax Court's processing of this case. When the Tax Court's first majority opinion announced the rule that conclusive proof was required from petitioners after being told by the Commissioner that the matter was a "test" case, the full court isued a regular opinion which was officially published. *Showell v. Commissioner,* 1594, 23 TC 495.

In that opinion fourteen Tax Court judges who were not present at the trial and who have never seen the petitioner Showell or

other witnesses found as fact that they believed petitioner only to the extent of $3,000.00 more than the Commissioner. On the other hand, the trial judge, Judge Withey, along with one other Tax Court judge, in another opinion, clearly showed that he believed it was impossible for petitioner to sustain his burden of proof without the daily individual bet slips. Thus, belief of the testimony made no difference to Judge Withey since the taxpayer had not maintained daily records which the trial judge concluded were an essential prerequisite to carrying the burden of proof.

However, after this Court remanded the case for sharper and more definitive findings of fact along with the statement that conclusive proof was not required of a taxpayer, the case became a memorandum opinion not officially published. Further, the opinion was written by a Tax Court judge who did not preside at the trial but is unconvinced by the *"record."* In other words, the Tax Court judges who did not observe the demeanor of the witnesses refuse to find that they did not believe the testimony. The only judge who can actually say whether he believed the witnesses or not, Judge Withey, no longer is active in the disposition of the case, probably because his earlier opinion indicated he did not think it involved the issue of credibility of the witnesses but failure to maintain certain records without which petitioners could not prevail.

Whether the Tax Court should be sustained on the ground that it had the right to disbelieve the testimony when it refuses to say it disbelieved the testimony and when the Tax Court judges who are unconvinced by the record never observed the witnesses is more than questionable it seems to petitioners. It may be true that a trial judge has the right not to believe testimony, but does this principle apply when:

(1) The Tax Court judge writing the opinion refuses to make such a finding, and

(2) The Tax Court judge writing the opinion was not the trial judge and never observed the witnesses, and

(3) The Tax Court judge who heard the case remains silent after indicating earlier that belief had nothing to do with the case, and

(4) The record is devoid of evidence to the contrary.

If this case is to be decided by the Tax Court, upon the unwritten premise that professional bookmakers, as a class, or this particular petitioner, as a member of that group, cannot be believed with respect to their income tax matters, whereas people engaged in other occupations can be believed, it should have been a simple matter for respondent's counsel to expose such proclivities on cross examination. Also, if that is the case, why did the Commissioner assert a deficiency based solely on the record maintained by such an individual? Further, if such a premise is correct, how does it avoid the testimony of Houston L. Walsh who was a nurseryman and City Manager? If the testimony of taxpayers is accepted or rejected, by reference to their occupation, should not some evidence be offered by the Commissioner to support the proposition that gamblers as a class are suspect when their testimony concerning their own income tax is involved? In recent years some Americans have been sent to jail for perjury upon the testimony of paid informers and ex-Communists, but their convictions were not set aside on the ground that uncontradicted testimony of such witnesses is per se unbelievable. If the United States can carry its burden of proving criminal guilt beyond a reasonable doubt in such cases, it would appear to follow that uncontradicted testimony must be followed even though one of the witnesses was engaged in the business of wagering.

Fourthly, it is significant to note the suden emergence of the *Cohan* case, *supra,* as a factor. This well-known decision, which was not mentioned by Judge Tietjens in the Tax Court's first opinion, was brought to the side of the stage by respondent's counsel in his brief filed in the first appeal before this Court. There it was argued that the Tax Court's decision was based:

" . . . apparently on the theory of *Cohan v. Commissioner,* 39 F. 2d 540 (C.A. 2d)." (Res.'s Br. No. 14760 at 8).

Thereafter, it was relied on by Judge Tietjens in the second memorandum opinion. Petitioners submit that the Tax Court is composed of able judges who do not overlook authority for their decisions. Consequently, it is suggested that the reliance upon the *Cohan* case, *supra,* was an afterthought, which does not save findings of fact and a decision which is clearly erroneous.

Fifth, it is necessary to put into perspective one of the statements made by respondent at the trial. There it was said, in an opening statement, that:

"This case here, your Honor, is one of a series of years of this taxpayer . . . " (R. No. 14760 at 40).

This is not the case. (R. No. 14760 at 57). The only other taxable year which the Commissioner of Internal Revenue has challenged with respect to petitioner's wagering income is 1948. In that year a deficiency in income tax of $1,711.86 was asserted in a statutory notice of deficiency. Thereafter, the alleged deficiency was paid, a claim for refund filed, and suit for recovery begun in the United States District Court in Phoenix, Arizona. *Showell v. U. S.* (D. C. Ariz., Dkt. No. 2185 Phx.). This suit has been stayed by the U. S. District Court pending the outcome of this appeal.

Since the Tax Court in the case before this Court has sustained deficiencies totaling $6,678.90 for the taxable year 1949, it is seen that only $8,390.76 in taxes and two taxable years are at stake.

Finally, petitioners feel it only fair that the record be clarified concerning the status of Houston L. Walsh as a disinterested witness. In the Tax Court's opinion, Judge Tietjens refers to him as Showell's "accountant." This is not correct unless that label is applied to anyone who assists a taxpayer in the use of an adding machine and who verifies daily totals. It seems to petitioners that this method of discrediting Walsh's testimony is indicative of the

weakness of the Tax Court's entire opinion. The record clearly shows that Mr. Walsh merely shared an office with petitioner in 1949, and there is absolutely no testimony that he was an accountant of any kind much less petitioner's accountant. In fact, he testified he was the owner of a nursery and a former City Commissioner and City Manager of Phoenix. (R. No. 14760 at 110). Nor was he in business of any kind with petitioner during 1949. Petitioners contend that the Tax Court, in a memorandum opinion written by a judge who never observed Mr. Walsh, cannot avoid the latter's uncontradicted testimony, which sustains the complete accuracy of Exhibit 3, simply by incorrectly referring to him as petitioner's accountant.

CONCLUSION

The decisions of the Tax Court in the instant cases are erroneous and should be reversed .

Dated: Phoenix, Arizona

December 10, 1957.

Respectfully submitted,

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Of Counsel

APPENDIX

EXHIBITS

Page references are to Transcript of Record No. 14760

PETITIONERS'	IDENTIFIED	OFFERED	RECEIVED
1	42	42	42
2	42	42	42
3	43	44	44
4	65	65	66
5	66	66	66
6	67	67	67
7	69	70	70
8	72	72	72
9	75	76	76
RESPONDENT'S			
A	117	117	117
B	117	117	117